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The Author, The IRS and Prepublication Expenditures

By DAVID WALTON*

I
Introduction

Authors may incur various costs in preparing a book for publication including expenditures for research and travel, secretarial help, art work, and office supplies. These costs are commonly referred to as prepublication expenditures. An author can incur these expenditures either as a professional author[1] in the trade or business of writing, or as an amateur author[2] who is not in the trade or business of writing, but who incurs such expenses in order to produce income.

An important issue for both amateur and professional authors is whether prepublication expenditures can be deducted when accrued (when they become payable) or incurred (when they are actually paid). The IRS has taken the position that such expenditures should be capitalized and then depreciated.[3] Though presumably both amateur and professional authors must capitalize their prepublication expenditures, the distinction between the two remains important because amateurs and professionals each have different cost recovery rules which allow different methods of depreciation.

Even though an author is required to capitalize prepublication expenditures, income received from the sale of a copyrighted work is reported as ordinary income and is not allowed capital gains treatment.[4] This produces an anomalous situa-

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1. *See* I.R.C. § 162 (1954). All cites are to the Internal Revenue Code of 1954 unless otherwise noted.

2. *See* I.R.C. § 212.

3. For purposes of this note, the depreciable basis of capitalized prepublication expenditures will be assumed to be the actual cost of such expenditures. Capitalizing an expenditure involves entering the expenditure on the taxpayers records as an asset. This capitalized cost then becomes the depreciable basis of the asset. *See* Rev. Rul. 68-194, 1968-1 C.B. 87; Rev. Rul. 73-395, 1973-2 C.B. 87.

4. *See* I.R.C. § 1221(3)(a).

tion; although treated as a capital expenditure for deduction purposes, a book is treated as a non-capital asset for income purposes.

This note will briefly discuss the distinction between amateur and professional authors and the history of non-capital gains treatment for books. It will then focus on the capitalization of prepublication expenditures with a discussion of each of the following: the history of the IRS positions on capitalization of prepublication expenditures, capitalization cases after 1976, and the Internal Revenue Code sections and IRS rulings relating to prepublication expenditures.

II
Amateur and Professional Status of Authors

Under the Internal Revenue Code, an author may write in one of three capacities: (1) As a professional in the trade or business of writing, (2) As an amateur who writes in order to produce income, or (3) As an amateur who merely writes as a hobby. A professional author who incurs expenses may deduct them under section 162,[5] while an amateur author who writes in order to produce income deducts expenses under section 212.[6]

The distinction between expenses arising in a trade or business versus expenses arising in the production of income is not always clear. In the case of *Hawkins v. Commissioner*,[7] the Tax Court distinguished between section 162 and section 212 expenditures as they relate to authors. *Hawkins* involved a taxpayer who wrote a book of poetry in her spare time. She paid a publisher $3,000 to publish the book in exchange for the right to receive $1.98 per copy for the first 4,000 copies sold. The taxpayer paid the $3,000 in 1975 and deducted it as a publishing expense on her 1975 tax return. The IRS disallowed the deduction claiming that neither section 162 nor section 212 applied. The Tax Court agreed with the IRS and gave some factors to be used in deciding whether an activity qualifies under section 162

5. I.R.C. § 162. This section allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on any trade or business.

6. I.R.C. § 212. This section allows a deduction for all ordinary and necessary expenses paid or incurred for the production or collection of income; or for the management, conservation, or maintenance of property held for the production of income; or, in connection with the determination, collection, or refund of any tax.

7. 48 T.C.M. (CCH) 439 TAX CT. MEM. DEC. (P-H) ¶ 79,101 (1979).

or section 212. The court said that in order to qualify as a trade or business there must be continuity and regularity in the activity.[8] There must also be an intent or motive to make a profit,[9] though the expectation of profit need not be reasonable but merely a good faith expectation.[10] Because the taxpayer was unable to show an intent or effort to continue writing with substantial regularity, the court held that she was not in the trade or business of writing.

The court also refused to allow the deduction under section 212 and described the applicability of section 212 as follows:

> The section 212(1) test of deductibility is similar to section 162 with the exception that the expense need not be incurred in a trade or business. To be deductible under section 212(1) petitioner must prove that the expenses relate to a profit-seeking purpose, and thus are 'business' expenses rather than 'personal expenses.'[11]

Unfortunately, the court did not describe the difference between a "profit-seeking purpose" and engaging in a trade or business and this decision offers little guidance for either amateur or professional authors.

In the recent case of *Snyder v. United States*,[12] the Tenth Circuit attempted to distinguish between sections 162 and 212 for an author deducting prepublication expenditures. The court said,

> [t]o qualify as a deduction under section 212, [ordinary and necessary expenses incurred for the conservation or maintenance of property] [it] must satisfy the same requirements that apply to a trade or business expense under section 162 except that the person claiming the deduction need not be in the trade or business.[13]

This distinction is not very helpful either, as it does not explain how a trade or business differs from an activity entered into for the production of income. The distinction is, evidently, one of degree. If an activity is not engaged in consistently enough to be a trade or business, but is pursued with sufficient regularity and profit intent to avoid its being classified as a hobby, then it

8. *See* Gentile v. Commissioner, 65 T.C. 1, 4 (1975).

9. *See* Bessenyey v. Commissioner, 45 T.C. 261, 274 (1965), *aff'd*, 379 F.2d 252 (2d Cir.), *cert. denied*, 389 U.S. 931 (1967).

10. *See* Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963).

11. *Hawkins*, 48 T.C.M. (CCH) at 439, 442. *See also* United States v. Gilmore, 372 U.S. 39, 45-46 (1963).

12. 82-1 U.S. Tax Cas. (CCH) ¶ 9285.

13. *Id.* at 83,692 (citing Fischer v. United States, 490 F.2d 218, 222 (7th Cir. 1973)).

can be properly classified as an activity entered into for the production of income. Thus, once it is determined that an activity is not a trade or business, one must decide if it is a hobby before classifying it as an activity for production of income.

Section 183 deals with activities not engaged in for profit, i.e. hobbies.[14] There is a rebuttable presumption that an activity is not a hobby if it shows a profit in at least two of the last five years of its operation.[15] The two-year/five-year test is only a presumption, however, and the issue of what constitutes a legitimate trade or business, or activity engaged in for production of income, and what constitutes a hobby has been heavily litigated.[16]

In order for a taxpayer to show that the business is not a hobby, it must be established that the taxpayer is engaged in the business with a primary purpose and intent of making a profit.[17] The Treasury regulations give nine factors to be used in making this determination: (1) the manner in which the taxpayer carries on the activity, (2) the expertise of the taxpayer or his advisors, (3) the time and effort expended by the taxpayer on the activity, (4) the expectation that the assets used in the activity will appreciate, (5) the success of the taxpayer in carrying on other similar or dissimilar activities, (6) the taxpayer's history of income or losses with respect to the activity, (7) the amount of occasional profits, if any, which are earned, (8) the financial status of the taxpayer, and (9) the elements of personal pleasure or recreation associated with the activity.[18] These factors will not be discussed in depth, but are included in order to expose the reader to the issues in this area.[19]

The recent Tax Court case of *Stahnke v. Commissioner* provides an example of how these factors are interpreted when applied to authors.[20] In this case, the author was conducting long-term research on the evolution of scorpions. Although the outcome of the research and any subsequent publication were

14. I.R.C. § 183.

15. I.R.C. § 183(d).

16. *See* 4A MERTENS, LAW OF FEDERAL TAXATION § 25.09. *See generally A Blend of Old Wines in a New Wineskin: Section 183 and Beyond*, 29 TAX L. REV. 347, (1974); *Deductions: tests for determining when an activity is a "business" rather than a "hobby,"* 4 TAX'N FOR LAW. 132, (1975).

17. *See* Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963).

18. Treas. Reg. § 1.183-2(b).

19. *See* note 16, *supra*.

20. 49 T.C.M. (CCH) 1629 (T.C.M. (P-H) 80,368) (1980).

unpredictable, and the expectation of profit was, therefore, uncertain,[21] the Tax Court held that expenditures for the project were properly deductible and not disallowed by the hobby loss limitations.[22] This narrows the situations where an author will be found to be engaged in a hobby by allowing even speculative, long-term research to be classified as a trade or business or as an activity engaged in for profit. Thus, when trying to determine whether an author is engaged in a hobby, one should not weigh the expectation of success as heavily as the other factors enumerated above. The courts have also indicated that just because the author enjoys writing does not mean it is a hobby. Along these lines, the Tax Court has said, "[A] business will not be turned into a hobby merely because the owner finds it pleasurable; suffering has never been made a prerequisite to deductibility."[23]

If an activity is deemed a hobby, the taxpayer's deduction for that activity cannot exceed the income generated from it.[24] This is known as the hobby loss limitation. The hobby loss limitation will produce a result different from sections 162 and 212 only when the writing deductions claimed for a particular year exceed the writing income for that year. For example, assume an author realizes $1,000 in income in year one and has $1,200 of deductible prepublication expenditures in the same year. If the writing is classified as a hobby, the author's deduction for prepublications expenditures is limited to $1,000 (the extent of his income). If it is not classified as a hobby, all $1,200 is deductible. Once the author is classified as an amateur or a professional, the matter of capitalizing any prepublication expenditures can then be addressed.

III
History of Noncapital Gain Treatment For Books

Before 1950, amateur authors received capital gains treatment for the proceeds from the sale of their literary works,

21. The Tax Court in *Stahnke* said that I.R.C. § 183 was enacted to replace I.R.C. § 270 and that the legislative history of § 183 indicated that deductibility of expenditures shouldn't be denied simply because profitability depends on a speculative, long-term project. *Id.* at 40 T.C.M. (CCH) 1633-34.

22. *See* text after note 24, *infra*, for a discussion of the hobby loss limitations.

23. Jackson v. Commissioner, 59 T.C. 312, 317 (1972).

24. I.R.C. § 183(b). A taxpayer may always deduct expenses normally allowed regardless if incurred in activities engaged in for profit. Examples of such expenses are: interest, taxes, and charitable contributions.

while professional authors were required to treat any proceeds from the sale of their works as ordinary income.[25] This difference in the treatment of professional and amateur authors was eliminated in 1950 when section 117(a)(1) was added to the Internal Revenue Code of 1939.[26] This code section specifically excludes from the definition of a capital asset copyrights as well as literary, musical or artistic compositions held by their creator or by someone whose basis in the work was determined by its creator.[27] A motivating factor behind this exclusion was General Eisenhower's sale of his memoirs in 1950 for one million dollars. This sale was treated as a long-term capital gain because Eisenhower was classified as an amateur author. The Senate Finance Committee specifically mentioned the Eisenhower sale in the legislative history of section 117(a)(1) and the statute has since been referred to as the "Eisenhower amendment."[28]

Because a copyrighted work in the hands of its creator, or someone whose basis is determined by its creator, is excluded from the definition of a capital asset, the only way it could receive capital gains treatment is under section 1231.[29] Section 1231, however, does not apply to books in the creator's hands or someone whose basis is determined by the creator, and uses language identical to section 1221 specifically excluding copyrights and literary, musical, or artistic compositions from the definition of 1231 assets.[30]

It is clear that Congress, through sections 1221 and 1231, intended that capital gains treatment not be given to writers. However, it seems inequitable that a book is treated as a capital asset when the author seeks to deduct prepublication expenditures associated with it, but when income is received from the same book, it is then treated as a noncapital asset making the income ordinary.[31]

25. Goldsmith v. Commissioner, 143 F.2d 466 (2d Cir. 1944), *cert. denied*, 323 U.S. 774 (1944); Fields v. Commissioner, 189 F.2d 950 (2d Cir. 1951). *See generally* Shine, *Some Tax Problems of Authors and Artists*, 13 TAX L. REV. 439 (1958).

26. I.R.C. § 117(a)(1) (1939). This is now I.R.C. § 1221(3).

27. I.R.C. § 1221(3)(A).

28. S. REP. No. 2375, 81st Cong., 2d Sess. 83-84 (1950) (Revenue Act of 1950).

29. I.R.C. § 1231 is a relief provision affording long-term capital gain treatment to certain property (usually business property) otherwise not classified as a capital asset.

30. I.R.C. § 1231(b)(1)(c).

31. Perhaps Congress did not consider this seeming inequity when they required authors to capitalize their prepublication expenditures. *But see* text accompanying

IV
A Pre-1976 History of IRS Positions On Capitalization of Prepublication Expenditures

Capitalizing, as opposed to immediately deducting expenditures when accrued or incurred, has traditionally been a controversial issue in tax law.[32] Not until comparatively recently, however, has the current expensing of an author's prepublication expenditures been questioned by the IRS.

In 1968, the IRS issued Revenue Ruling 68-194 requiring taxpayers not in the trade or business of writing, but deducting prepublication expenditures as activities for the production of income (§ 212), to capitalize all prepublication expenditures.[33] A portion of the revenue ruling said,

> [t]he taxpayer's expenses for secretarial help, art work, supplies, postage, and travel are directly attributable to the production and copyrighting of the manuscript. Accordingly, such expenses are not deductible for Federal income tax purposes, but rather are capital expenditures the total of which is the taxpayer's basis of the property.[34]

The IRS justified this position by reasoning that, even though section 212 allows a deduction for costs incurred in a transaction entered into for profit, section 263 says that amounts expended to increase the value of property are capital expenditures and are, therefore, nondeductible.[35] The Service pointed out that section 1012[36] provides that the basis of the property should be its cost.[37] Thus, under section 263 and section 1012, an amateur author should add prepublication expenditures to his basis in the book and should not deduct such expenditures as accrued or incurred.[38] The result is that when

notes 86-89, *infra*, quoting Senator Ribicoff's statement before the Senate Finance Committee recognizing this inequity, 122 Cong. Rec. § 5984 (daily ed. Apr. 27, 1976).

32. *See* Commissioner v. Idaho Power, 418 U.S. 1 (1974) (this case reviews much of the controversy surrounding capitalization).

33. Rev. Rul. 68-194, 1968-1 C.B. 87.

34. *Id.* at 88.

35. I.R.C. § 263.

36. I.R.C. § 1012.

37. Rev. Rul. 68-194 at 88, *supra* note 33.

38. As discussed earlier, amateur authors are not in the trade or business of writing but are engaged in an activity for the production of income and they deduct their expenditures under I.R.C. § 212, and not under I.R.C. § 162. Since this revenue ruling applied to § 212 expenditures, it applies to amateur and not professional authors.

the book is sold, the author may recover all of the basis before recognizing any income.[39] This recovery scheme is commonly called the "open transaction doctrine" and will be discussed later in more detail.

An example of this capitalization and recovery scheme would be as follows: author incurs $10,000 in prepublication expenditures which are capitalized and added to the book's basis resulting in a $10,000 net basis in the book. The author sells the book and receives $5,000 in year one and $15,000 in year two. In year one, the author does not have to recognize any income, but instead recovers $5,000 of his capitalized basis. In year two, the author must recognize $10,000 in income because he will recover his remaining $5,000 basis, with the remainder ($10,000) being recognized as ordinary income. All proceeds received after year two will be recognized as ordinary income because there will be no basis left in the book to recover. Section 280,[40] which was passed in 1976 and which will be discussed later, may require prepublication expenditures to be capitalized and depreciated under the income forecast method. Accordingly, the IRS will most likely argue that any author invoking the open transaction doctrine of Revenue Ruling 68-194 should depreciate capitalized expenditures under the income forecast method.[41]

The income forecast method requires that an author estimate the total income to be received from the book and then amortize the capitalized cost of the book as follows:[42]

$$\frac{\text{Current Year's Income}}{\text{Estimated Total Income}} \times \frac{\text{Capitalized}}{\text{Cost of Book}} = \frac{\text{Deduction}}{\text{For Year}}$$

This method of depreciation is based on the rate of income generated by the asset rather than on the passage of time, as are most other depreciation methods. Thus, depreciation deductions are directly related to how much revenue a book generates in a particular year. In most cases, this method of depreciation will be helpful to authors because it provides for a larger deduction when income is greater, thus preventing

39. See text accompanying note 49, *infra*, for a discussion of the current vitality of this doctrine.

40. I.R.C. § 280.

41. One should note, however, that Rev. Rul. 68-194 has not been revoked and is still valid today.

42. CCH, Standard Federal Tax Reports, ¶ 2297YH. 20, 1981. *See* Rev. Rul. 60-358, 1960-2 C.B. 68.

higher income from pushing the author into progressively higher tax brackets.

Revenue Ruling 68-194 applies only to amateur authors. In 1971, the IRS extended its capitalization position to professional authors by challenging the deduction of prepublication expenditures by a professional writer. The dispute went to court and in the decision of *Stern v. United States*,[43] a Federal District Court in California held that a writer engaged in the trade or business of writing did not have to capitalize expenses incurred in preparing a book. The court said, "[t]he expenses were ordinary and necessary expenses of carrying on plaintiff's business of a writer, and hence are deductible under 26 U.S.C. § 162(a)."[44] The IRS did not appeal the decision because of a pre-trial stipulation that, if the taxpayer was found to be in the trade or business of writing, the expenditures would be ordinary and necessary and thus currently deductible.[45]

In response to this decision, the IRS issued Revenue Ruling 73-395,[46] stating that it was refusing to follow the decision in *Stern*. Revenue Ruling 73-395 concerned a taxpayer engaged in the trade or business of writing who sought to deduct expenditures incurred in writing, editing, designing and securing art work for his textbooks as research and development expenditures.[47] The IRS said that these expenditures did not qualify as research and development expenditures because they were not research in the "laboratory sense."[48] Capitalization of these expenditures was, therefore, required under section 263. A portion of Revenue Ruling 73-395 says that:

> [e]xpenditures that are directly attributable to producing and copyrighting a manuscript of a literary composition by a taxpayer result in the creation of an asset having a useful life that extends substantially beyond the close of the taxable year and are thus capital in nature and not deductible for Federal in-

43. 27 A.F.T.R.2d (P-H) 71-1148, 71-1 U.S. Tax Cas. (CCH) ¶ 9375 (1971).

44. *Id.* at 71-1149.

45. *Id.* The issue in *Stern* was whether travel expenses incurred by the author were deductible as section 162 ordinary and necessary business expenses. The stipulation was that if the taxpayer was found to be in the trade or business of writing the travel expenditure would be deductible under § 162. Evidently, the capitalization issue was an afterthought by the IRS.

46. Rev. Rul. 73-395, 1973-2 C.B. 87.

47. *See* I.R.C. § 174 for rules regarding research and development expenditures.

48. Treas. Reg. § 1.174-2(a)(1) (1982), defines research and development expenditures in the laboratory sense specifically excluding research in connection with literary, historical, or similar projects.

come tax purposes.[49]

Revenue Ruling 73-395 officially extended the IRS Revenue Ruling 68-194 requirement of capitalization of prepublication expenditures by amateur writers, attempting to deduct under section 212, to professional writers attempting to deduct under section 162. However, Revenue Rulings 68-194 and 73-395 are not identical in all respects. Under Revenue Ruling 73-395, the basis of a writing is depreciated over the legal life or the actual useful (income-earning) life of the copyright. Under Revenue Ruling 68-194, the basis of the book is recovered before any income is recognized under the open transaction doctrine recovery scheme.

The method of cost recovery commonly known as the "open transaction" doctrine, stems from the well known case of *Burnet v. Logan*.[50] This doctrine usually covers situations where neither the value of the property received nor the value of property given in exchange can be determined in a transaction.[51] Because an author usually sells a book under a royalty contract, neither the value of the book nor the value of the royalties can be determined with certainty at the date of sale. Consequently, the arrangement can qualify for open transaction treatment.

The open transaction doctrine, however, may no longer apply to amateur writers. Its current vitality is questionable in light of the 1980 amendment to section 453 dealing with installment sales.[52] The Senate Finance Committee, commenting on the amendment to section 453, stated that "[i]n any event, the effect of the new rules is to reduce substantially the justification of treating transactions as 'open' and permitting the use of the cost-recovery method sanctioned by *Burnet v. Logan*."[53] The amendment to section 453 simply authorizes the Treasury to issue regulations "where the gross profit or the total contract price (or both) cannot be readily ascertained."[54] Proposed regulations have recently been issued which will limit the open transaction doctrine to, as the Senate Finance Committee put it, "those rare and extraordinary cases involving sales for a

49. Rev. Rul. 73-395, *supra* note 46.
50. 283 U.S. 404, 51 S. Ct. 550 (1931).
51. *See* I.R.C. § 453(i)(2).
52. I.R.C. § 453(j)(2).
53. S. REP. NO. 96-1000, *Comm. on Finance*, 96th Cong., 2d Sess. 24 (1980).
54. I.R.C. § 453(i)(2).

contingent price where the fair market value of the purchaser's obligation cannot be reasonably ascertained."[55]

If the open transaction doctrine is no longer applicable to amateur authors, amateurs should probably use the same depreciation method as professionals. It is not entirely clear, however, which method professionals should use. Revenue Ruling 73-395 says that, because the expenditures are capitalized, the appropriate cost recovery method is depreciation under § 167.[56] As discussed above, however, section 280 requires cost recovery under the "income forecast method" as the only allowable method under section 167.[57]

The IRS has not yet indicated which cost recovery method depreciation an amateur should use but logic would suggest that general section 167 is appropriate, as it was required for professional authors in factually identical situations. The distinction between methods will make little difference for an amateur author falling under the hobby loss rules.[58] Because an amateur author, classified as writing for a hobby, only deducts expenses equal to income, depreciation under section general 167 principles or under the income forecast method would be limited to income received.

V
Capitalization After 1976: *Faura v. Commissioner*

Faura v. Commissioner[59] is a Tax Court case very similar to *Stern v. United States*.[60] *Faura* involved a professional author, in the trade or business of writing, who in 1974 incurred expenditures for office, rent, telephone, research, entertainment, and transportation in connection with his writing of two books. Mr. Faura deducted these expenditures on his 1974 tax return as ordinary and necessary business expenses under section 162. The IRS disallowed the deduction for these prepublication expenditures, claiming that the expenditures should be capitalized and depreciated over the life of the books. In 1980, the Tax Court decided the dispute in favor of Mr. Faura, holding that he could deduct his prepublication expenditures as busi-

55. S. REP. No. 96-1000, *supra* note 53. *See also*, Proposed Regulations § 1.453-1(c).
56. Rev. Rul. 73-395 at 88, *supra* note 46.
57. I.R.C. § 280(b).
58. *See* text accompanying notes 14-16, *supra*.
59. 73 T.C. 849 (1980).
60. Stern v. U.S., 27 A.F.T.R.2d (P-H) at 71-1148.

ness expenses. The IRS unsuccessfully argued the capitalization rationale taken in Revenue Rulings 68-194 and 73-395. They claimed that section 263, which requires capitalization of amounts paid to increase the value of property having a useful life substantially beyond the taxable year, takes precedence over section 162 which allows a deduction for ordinary and necessary business expenditures.[61] Because the expenditures were required to be capitalized, the IRS argued that, under section 1012, these expenditures should be capitalized by adding them to the basis of the book and then depreciating them under section 167 over the legal or useful income-producing life of the book.

In rejecting these arguments, the Tax Court described the history of tax cases dealing with writers and movie producers and stressed the fact that courts have consistently allowed deductions of prepublication expenditures as ordinary and necessary business expenses in hobby loss,[62] entertainment,[63] travel,[64] research,[65] and trade or business cases.[66] However, none of the cases reviewed by the Tax Court mentioned capitalization versus expensing, but dealt instead with whether the various categories of expenditures were properly allowed as deductions under the Internal Revenue Code. The courts in all of these cases assumed that, if these expenditures were properly allowed as deductions under the Code, then they would be deductible as trade or business (section 162) or production of

61. The IRS cited Treas. Reg. 1.263(a)-2 (1980), which gives examples of capital expenditures to support this statement: "(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. (b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments." Note that section (a) refers to "similar property" which infers machinery and other expenses normally associated with preparing a book. And section (b) refers to expenses in securing a copyright. Does this suggest only attorney fees and legal costs or does it include prepublication expenditures?

62. *See* Doggett v. Burnet, 65 F.2d 191 (D.C. Cir. 1933). (A discussion of how the hobby loss rules apply to authors.)

63. *See* May v. Commissioner, 39 B.T.A. 946 (1939). (Allowed authors to deduct entertainment expenses.)

64. *See* Delmar v. Commissioner, 7 B.T.A.M. (P-H) ¶ 38,155 (1938); Sandrich v. Commissioner, 5 T.C.M. (CCH) 234, Supplemental Opinion, 5 T.C.M. (CCH) 570, 15 T.C.M. (P-H) ¶ 46,082 (1946); Schumlin v. Commissioner, 16 T.C. 407 (1951); Kluckhohn v. Commissioner, 18 T.C. 892 (1952). (Allowed authors to deduct travel expenses.)

65. *See* Brooks v. Commissioner, 274 F.2d 96 (9th Cir. 1959). (Allowed authors to deduct research expenses.)

66. *See* Rood v. United States, 184 F. Supp. 791 (D. Minn. 1960) (allowed authors to deduct ordinary and necessary expenses incurred in a trade or business).

income (section 212) expenses. In addition to the consistent case holdings that prepublication expenditures are currently deductible, the Tax Court relied on section 2119 of the Tax Reform Act of 1976, which revoked Revenue Ruling 73-395 for certain taxpayers.[67] The court in *Faura* was of the opinion that section 2119 permitted a deduction of prepublication expenses in 1974 in spite of Revenue Ruling 73-395.[68]

VI
Section 2119 of the Tax Reform Act of 1976

Section 2119[69] was passed as part of the 1976 Tax Reform Act but is not found in the Internal Revenue Code because it is a congressional directive to the IRS to revoke Revenue Ruling 73-395.[70] This statute was passed because of congressional displeasure with the IRS policy on capitalization of prepublication expenditures. It directs that the application of "sections . . . 162, . . . [and] 263 . . . of the Internal Revenue Code of 1954 to any prepublication expenditure shall be administered—(1) without regard to Revenue Ruling 73-395, and (2) in the manner in which such sections were applied consistently by the taxpayer to such expenditures before the date of the issuance of such revenue ruling."[71]

In *Faura*, the IRS argued that section 2119 did not apply to authors but instead applied only to publishers and the publishing industry.[72] Section 2119 defines prepublication expenditures as, "expenditures paid or incurred by the taxpayer (in connection with his trade or business of *publishing*) for the writing, editing, compiling, illustrating, designing, or other development or improvement of a book, teaching aid, or similar product."[73] After examining the legislative history of section 2119, the Tax Court held this definition of prepublication expenditures was meant to include authors.[74]

The original version of section 2119 from the House Ways and Means Committee revoked Revenue Ruling 73-395 to pub-

67. *Faura*, 73 T.C. at 857-859.
68. *Id.*
69. Pub. L. No. 94-455, § 2119, 1976-3 C.B. 388.
70. *See Faura*, 73 T.C. at 859.
71. § 2119(a), *supra* note 69.
72. *Faura*, 73 T.C. at 857-859.
73. § 2119(c) (emphasis added), *supra* note 69.
74. *Faura*, 73 T.C. at 859.

lishers only.[75] When the Senate Finance Committee received this House version, Senator Ribicoff proposed an amendment to the House version stating that, "the amendment would suspend the application of Revenue Ruling 73-395 so as to permit authors and publishers to currently deduct prepublication expenditures. Section 1306 of H.R. 10612 [the original version], extends this relief only to publishers."[76] Senator Ribicoff then went on to point out the plight of the author under the present circumstances by stating,

> What makes Revenue Ruling 73-395 all the more unfair is the fact that while it requires expenditures to be depreciated, Section 1221(3) of the Code prohibits authors from treating their output as 'capital assets.'
>
> In other words, without the amendment I am proposing authors will be taxed at the higher 'ordinary income' rates while they will only be able to depreciate expenses. This is patently unfair.[77]

When the bill went to conference, the conference agreement read as follows: "The conference agreement follows the House bill with necessary technical changes."[78] The Tax Court interpreted the language "necessary technical changes" in the conference agreement and the use of the personal pronoun "his" in section 2119 referring to "his trade or business of publishing"[79] as meaning that Congress intended to include authors under section 2119.[80] Thus, because Faura was consistently deducting his prepublication expenditures before Revenue Ruling 73-395 was issued, he was found to be in the trade or business of writing and could continue to deduct them under section 2119.

Judge Chabot dissented in *Faura*, pointing out that Senator Ribicoff's proposed amendment was never accepted. The Senate Finance Committee report states that the Senate version of section 2119 was the same as the House version, "except that it extends its application to authors."[81] The Senate Finance Committee version, however, was never considered by the

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75. H. REP. NO. 94-658, 94th Cong., 1st Sess. 337 (1975), 1976-3 C.B. 1029. The committee referred to the "publishing industry" and its concerns over 73-395.

76. 122 Cong. Rec. § 5984 (daily ed. Apr. 27, 1976).

77. *Id.*

78. S. REP. NO. 94-1236, 94th Cong., 2d Sess. 502 (1976), 1976-3 C.B. 906.

79. § 2119(c), *supra* note 69.

80. *Faura*, 73 T.C. at 859.

81. S. REP. NO. 94-938, 94th Cong., 2d Sess. 405, 1976-3 C.B. 443.

Senate because it was withdrawn before the Senate ever saw it.[82] Thus, the bill passed by both houses of Congress was the original House version which, in Senator Ribicoff's own words, excluded authors. Judge Chabot in his dissent goes on to point out that the Senate Finance Committee amendment, which was never adopted, would have defined prepublication expenditures exactly as the House version had except it would have added "writing" as follows: "expenditures paid or incurred by the taxpayer (in connection with his trade or business of *writing or* publishing) . . . ."[83] Thus, he argued that any "technical changes" made would have to include the word "writing" if Congress meant to include authors under section 2119. Judge Chabot also stated that the word "his" was included in the original House version and thus could not be interpreted as referring to authors, as the majority held.[84]

Upon close study, the dissenting argument is very persuasive. The two concurring judges in *Faura* agreed with the dissent's view that section 2119 did not apply to authors.[85] Evidently, the concurring judges relied not on section 2119, but rather on the earlier decisions allowing deductions for prepublication expenditures, and upon their own interpretation of the Internal Revenue Code. Perhaps one reason for the Tax Court's refusal to require capitalization of prepublication expenditures was because it felt that it was manifestly unfair to authors.

The recent case of *Encyclopaedia Britannica, Inc. v. Commissioner*,[86] illustrates the Tax Court's opinion that capitalization is unfair to authors. In this case, a publisher was allowed to deduct expenditures incurred in producing and copyrighting a book during the tax years 1966 and 1967. In addition to relying on section 2119, the Tax Court justified the deduction stating:

> To require capitalization in the instant case would be to require what neither the Code nor any sound theory of taxation requires: that business realities be subordinated to an overzealously applied theory of capitalization. It is a fact that the expenses before us are the normal costs of petitioner's op-

82. 122 Cong. Rec. § 12613 (daily ed. July 27, 1976).

83. H.R. 10612, 94th Cong., 2d Sess. (1976), *Faura*, 73 T.C. at 865 (Chabot, J., dissenting).

84. *Faura*, 73 T.C. at 866 (Chabot, J., dissenting).

85. *Faura*, 73 T.C. at 862 (Tannenwald, J., and Nims, J., concurring).

86. 41 T.C.M. (CCH) 1573 (1981).

eration as a publisher. To require capitalization would be to elevate form over substance.[87]

Thus, it appears that in addition to relying on section 2119, the Tax Court was of the opinion that capitalization of prepublication expenses had no sound foundation in the Internal Revenue Code. This is a logical viewpoint because the only authorities at that point in time (pre-1976) requiring capitalization of prepublication expenditures were Revenue Rulings 68-194 and 73-395. Revenue Rulings are only the opinion of the IRS and do not have the force and effect of a statute.[88]

Faura was appealed to the Ninth Circuit Court of Appeals on January 5, 1981, and was dismissed on motion of the IRS on April 24, 1981.[89] *Faura* has been supported in the recent case of *Snyder v. U.S.*.[90] In this case, the Tenth Circuit Court of Appeals allowed the taxpayer to deduct prepublication expenditures and refused to require capitalization. The tax years involved were 1972 and 1973. The court made no mention of either section 2119 or section 280 in its decision. The court did cite *Faura* as authority for the proposition that prepublication expenditures need not be capitalized, and referred to *Faura* as an "opinion generally helpful in describing treatment of authors' expenses."[91] Evidently, the Tenth Circuit is of the opinion that *Faura* was decided correctly and probably agrees with the proposition that section 2119 applies to authors.

Faura has also been recently criticized by the Seventh Circuit Court of Appeals in *Encyclopaedia Britannica v. Commissioner*.[92] In this case, the Seventh Circuit reversed the Tax Court, holding that Encyclopaedia Britannica was required to capitalize certain prepublication expenditures. Encyclopaedia Britannica had made advances to another publishing company for work on a manuscript to be used in putting together a book. The court said that even though section 2119 applies to publishers, it was inapplicable in this case because Encyclopaedia Britannica did not have a consistent practice of deducting this type of expenditure prior to 1976. Thus, under these circum-

87. *Id.* at 1582.

88. *See* 9 MERTENS, LAW OF FEDERAL INCOME TAXATION, Section 49.85; *Faura*, 73 T.C. at 863-864 (Chabot, J., dissenting).

89. Docket No. 81-7003. Telephone conversation on August 20, 1982 with a clerk for the Ninth Circuit Court of Appeals in San Francisco, California.

90. 82-1 U.S. Tax Cas. (CCH), *supra* note 12.

91. *Id.* at 83,693.

92. 82-2 U.S. Tax Cas. (CCH) ¶ 9530, Slip Opinion No. 81-2785, August 9, 1982.

stances, the IRS was justified in requiring capitalization. The court then criticized *Faura* as failing "to articulate a persuasive rationale for [its] result,"[93] observing that all the cases that the Tax Court relied on in *Faura* dealt only with whether certain expenditures were deductible at all by authors, not whether they should be capitalized instead of deducted. However, the Seventh Circuit refrained from expressly disapproving of *Faura* stating,

> Yet despite all this we need not decide whether *Faura* is good law, and we are naturally reluctant to precipitate a conflict with the Tenth Circuit. The Tax Court interpreted *Faura* too broadly in this case. As we interpret *Faura* its principle comes into play only when the taxpayer is in the business of producing a series of assets that yield the taxpayer income over a period of years, so that a complex allocation would be necessary if the taxpayer had to capitalize all his expenses of producing them.[94]

According to this statement, the Seventh Circuit is of the opinion that recurring expenses of an author are non-capital in nature and thus are deductible. Unfortunately, the case made no mention of section 280. The failure to discuss section 280 is most likely based on the fact that the tax years involved were 1966 and 1967 and section 280 was passed in 1976. This case involved a publisher, not an individual author (as did *Faura*) and thus is not precisely on point with *Faura*. *Encyclopaedia Britannica* is, however, illustrative of the judicial uncertainty surrounding prepublication expenditures and should put one on notice that the reasoning in *Faura* is not necessarily universally accepted.

VII
Internal Revenue Code Section 280

The Tax Reform Act of 1976 added section 280 to the Internal Revenue Code. A portion of section 280 reads as follows:

> (a) *General Rule.*—In the case of an individual, except in the case of production costs which are charged to capital account, amounts attributable to the production of a film, sound recording, book, or similar property which are otherwise deductible under this chapter shall be allowed as deductions only in accordance with the provisions of subsection (b) . . . .

93. *Id.* at ¶ 84892.
94. *Id.* at ¶ 84893.

> (b) *Proration of Production Cost Over Income Period.*—Amounts referred to in subsection (a) are deductible only for those taxable years ending during the period during which the taxpayer reasonably may be expected to receive substantially all of the income he will receive from any such film, sound recording, book, or similar property. The amount deductible for any such taxable year is an amount which bears the same ratio to the sum of all such amounts (attributable to such film, sound recording, book, or similar property) as the income received from the property for that taxable year bears to the sum of the income the taxpayer may reasonably be expected to receive during such period.[95]

This statute was passed in response to abuses in tax deductions by motion picture tax shelters.[96] Two types of shelters commonly used prior to 1976 were the film purchase shelter and the production company shelter.

In the film purchase shelter, a limited partnership is formed to purchase the rights to a completed film. The purchase price is heavily leveraged and accelerated depreciation is taken on the film. This accelerated depreciation is passed through to the limited partners, giving them the advantage of tax deferral.[97]

The production company shelter involves a partnership which enters into an agreement with a studio or independent producer to produce a film. The partnership uses the cash method of accounting to write off the production costs as paid. The partnership is usually heavily leveraged, paying the production costs with borrowed funds and passing the deduction on to the partners. This shelter also provides the taxpayer with a tax deferral through loss deductions.[98] Section 280 was enacted to remedy these perceived abuses of tax deductions.[99] Books were included under section 280 because, as the Joint Committee on Taxation put it, "Congress was informed that the production company shelter may be expanding into other areas, such as the publishing field."[100]

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95. I.R.C. § 280.

96. General Explanation of the Tax Reform Act of 1976, Joint Committee on Taxation, H.R. 10612, 94th Congress, Pub. L. No. 94-455, Dec. 29, 1976, 67-70, 1976-3 C.B. *See also Motion Picture Investments Adversely Affected by TRA but Opportunities Remain*, 46 J. TAX'N 140, 142, 1977.

97. *Id.*

98. *Id.* at 70-71.

99. *Id.* at 67.

100. *Id.* at 72.

Nothing in the legislative history of section 280, nor in the Act itself, mentioned authors or prepublication expenditures. Apparently, the only reason books were included was because of fears that the motion picture type shelters would expand into books. With this motive for including books, one may question whether Congress really intended that section 280 apply to book authors. However, section 280 does say "books" without any qualifications and, because of this language, it appears that the IRS will have a very strong case in applying it to authors.

Section 280 basically requires that all publication expenditures, which are not required to be capitalized under any other Code provision, should be capitalized under section 280. The capitalized expenditures are then deducted in proportion to the estimated total income to be received from the book. This is the income forecast method.[101]

Section 280 applies to prepublication expenditures "if such costs are paid or incurred after December 31, 1975, and the principal production of the property began after that date. In the case of a book, principal production begins with the preparation of the material for publication."[102] Thus, it appears that under section 280, an author who began preparing a book for publication after December 31, 1975, must capitalize and depreciate under the income forecast method any prepublication expenditures not required to be capitalized under any other code section. The Tax Court in *Faura* stated that "section 280, as enacted applies only to amounts paid or incurred after December 31, 1975, with respect to property the principal production of which began after December 31, 1975."[103]

This approach of capitalizing expenses for two different purposes (one because other code sections require it and the other because section 280 requires it) could lead to the peculiar result of having an author divide and depreciate his prepublication expenditures under two different methods. For example, suppose an author incurs research expenditures in addition to general secretarial and office expenditures in the course of preparing a book. The author will not be able to deduct the research expenses as research and experimental expenses under section 174 because research in connection with

101. *See* Rev. Rul. 60-358, 1960-2 C.B. 68.
102. Joint Committee on Taxation at 74, *supra* note 96.
103. *Faura*, 73 T.C. at 861.

literary subjects is specifically excluded.[104] In a recent letter ruling, the IRS said such an expenditure should be capitalized under section 263.[105] Since this expenditure is already required to be capitalized under another Code section—263, it qualifies as a production cost "charged to a capital account" as defined by section 280.[106] Thus, instead of depreciating it under the income forecast method prescribed by section 280, the research expenditure would be depreciated under general depreciation methods specified in section 167. The remaining prepublication expenditures (secretarial and office costs) are not required to be capitalized by any other code section, but would be capitalized under section 280 and then depreciated under the income forecast method. All of the prepublication expenditures are capitalized, but they are depreciated under different methods. An astute author should determine which depreciation method is most favorable and then try to either fit all or most of his expenditures under section 280 or try to justify capitalization under other code sections such as section 263. In order for the example to work, there must be a choice of depreciation methods open to an author under section 167. In addition, the utility of this suggestion may be questionable in light of revenue rulings dealing with the income forecast method.

The IRS specifically addressed the use of the income forecast method in Revenue Rulings 79-285[107] and 68-358[108] stating that it is the proper method for computing depreciation for assets that generate an uneven flow of income. Revenue Ruling 79-285 requires that the income forecast method be used for books and other intangible assets, stating that "[a]ny method other than the straight line and income forecast methods of computing depreciation deductions for intangible assets must clearly reflect income as provided in section 446(b) of the Code."[109] In light of these revenue rulings, the IRS may well argue that, regardless of whether prepublication expenditures are capitalized under section 280 or any other Code section, the only allowable depreciation methods are the income forecast

104. Treas. Reg. 1.174-2(a)(1) (1982), *supra* note 48.
105. Letter Ruling 7921008, January 29, 1979.
106. I.R.C. § 280(a).
107. Rev. Rul. 79-285, 1979-2 C.B. 91.
108. Rev. Rul. 60-358, 1960-2 C.B. 68. *See also* Rev. Rul. 64-273, 1964-2 C.B. 62.
109. Rev. Rul. 79-285 at 92. Section 446(b) requires that a taxpayer's method of accounting clearly reflect income.

method or straight line method. If this is the case, then there will be no choice of depreciation methods as discussed in the example, and the two-method depreciation scheme in the example will not be possible.

Because Revenue Ruling 73-395 requires capitalized prepublication expenditures to be depreciated under section 167 principles, the question arises as to whether such expenditures, incurred after 1981, are depreciable under the accelerated cost recovery system (ACRS) rules.[110] The IRS would probably say no, relying on the language of section 168, which says that section 168 property does not include property that is properly depreciated under any method not expressed in a term of years.[111] The income forecast method is not expressed in a term of years but rather is based on a ratio of current versus expected income.[112] According to Revenue Rulings 60-358 and 79-285, the income forecast method is the proper depreciation method for books and thus ACRS should not apply. It should also be noted that only tangible section 167 property qualifies for ACRS.[113]

Capitalized prepublication expenditures are most likely not tangible property. The courts have held that certain types of films and tapes are tangible property for section 38 investment tax credit purposes.[114] But, the IRS has said that even if such films and tapes are tangible property for section 38 purposes, they are intangible for depreciation purposes.[115] Neither the IRS nor the courts have specifically stated whether capitalized prepublication expenditures are tangible property. Because they are similar to tapes and films, it is most likely that they are intangible for purposes of section 168 and thus not eligible for ACRS. However, they are still eligible for depreciation under section 167.[116]

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110. The accelerated cost recovery system is part of the Economic Recovery Tax Act of 1981 and allows more rapid depreciation than was previously granted under I.R.C. § 167.

111. I.R.C. § 168(e)(2).

112. *See* Rev. Rul. 60-358, 1960-2 C.B. 68.

113. I.R.C. § 168(c)(1).

114. *See* Walt Disney Productions v. U.S., 549 F.2d 576 (9th Cir. 1977); *cf.* Texas Instruments v. U.S., 551 F.2d (5th Cir. 1977).

115. Letter Ruling 7802004, September 28, 1977.

116. Rev. Rul. 73-395 at 88, *supra* note 52.

VIII
The Relationship Between Section 2119 and Section 280

Because section 280 appears to nullify all that section 2119 gave to authors, one may very well inquire as to the purpose of section 2119. The explanation given by the IRS is that section 2119 is applicable to tax years beginning before December 31, 1976, and that after December 31, 1976, section 280 applies.[117] Section 2119 states that it applies to taxable years beginning before "the date on which regulations dealing with prepublication expenditures are issued."[118] Evidently, the IRS is of the opinion that section 280 is the regulation dealing with prepublication expenditures that is to replace section 2119. The problem with this reasoning is that section 280 is an Internal Revenue Code section, not a Treasury Regulation. Section 2119 clearly provided that regulations to specific code sections would be issued.[119] This difference in terminology is hard to understand in light of the fact that the same committees during the same session of Congress put together sections 280 and 2119 as part of the same act (the 1976 Tax Reform Act). Also, as mentioned earlier, neither section 280 itself nor the legislative history mentions authors or prepublication expenditures. In light of the legislative history of section 280 and its stress on motion picture shelters, one may question whether section 280 was even meant to cover authors' prepublication expenditures.[120]

The Tax Court in *Faura* agrees that section 280 applies only to amounts paid or incurred after December 31, 1975.[121] But, the Court refused to commit itself on whether section 280 applies to authors.[122] As the law stands now, the IRS will most likely require that an author capitalize prepublication expenditures under section 280. The IRS opinion is not the final word,

117. Letter Ruling 7921008, *supra* note 107. *See also* Letter Ruling 8104112, October 30, 1980.

118. § 2119(a), *supra* note 69.

119. *Id.*

120. In *Faura*, the Tax Court stated, "The legislative history of section 280 indicates that it was aimed primarily at investors in motion picture (tax) shelters rather than producing artists." 73 T.C. at 860, n.14.

121. *Faura*, 73 T.C. at 861.

122. *See Faura*, 73 T.C. at 861, n.15.

however, and some specific legislation by Congress would be most helpful in this area.

Another example of the confusion caused by sections 2119 and 280 is that section 280 simply refers to "individuals" and to "amounts attributable to the production of a film, sound recording, [or] book."[123] It makes no distinction between amateur and professional authors. While section 2119 revoked only Revenue Ruling 73-395, Revenue Ruling 68-194 was never mentioned and is, apparently, still valid.[124] As stated earlier, Revenue Ruling 68-194 requires amateur authors to capitalize all prepublication expenditures and depreciate them only when income is recognized. Thus, prepublication expenditures of authors not in the trade or business of writing should not fall under section 280, as they are already chargeable to a capital account under 68-194's interpretation of the Code. Section 280 applies only to expenditures which are "otherwise deductible"[125] and, because Revenue Ruling 68-194 prohibits amateur authors from deducting prepublication expenditures, such expenditures are not "otherwise deductible." Therefore, even if section 280 is meant to apply to authors not in the trade or business of writing, the IRS position in Revenue Ruling 68-194, that all prepublication expenditures of such authors are properly capitalizable under other code sections, leaves no expenditures falling under section 280.

IX
Conclusion

In the past, the courts and the IRS have differed on whether authors' prepublication expenditures should be capitalized. Now, with the enactment of sections 2119 and 280, the issue has become even more confused. The recent judicial interpretations, as indicated by *Faura*, *Snyder*, and *Encyclopaedia Britannica* have yet to provide guidance for authors under the current statutory scheme. The import of all this, for authors, is that until sections 2119 and 280 are interpreted by a court dealing with an author deducting post-1976 prepublication expendi-

123. I.R.C. § 280(a).

124. If the Tax Court is really serious when it says that capitalization is manifestly unfair to authors and "neither the Code nor any sound theory of capitalization" requires capitalization haven't they impliedly declared Revenue Ruling 68-194 as invalid?

125. I.R.C. § 280(a).

tures, the capitalization question will continue largely unsettled.

According to the IRS, after December 31, 1976, all authors, professional and amateur, will have to capitalize all of their prepublication expenditures. General operating expenses such as office expenses and clerical help, not reasonably allocable to the preparation of a writing, can still be currently deducted by the author in the trade or business of writing, but those expenditures made in preparation of a writing must be capitalized. Once it is determined which costs are allocable to the writing, the author must then determine whether he or she is in the trade or business of writing. If the author is not in the trade or business of writing, then Revenue Ruling 68-194 and the hobby loss provisions come into play.[126] Though Revenue Ruling 68-194 requires cost recovery under the open transaction doctrine, in light of current changes to section 453, it is doubtful that this method can still be used. The amateur should use either a section 167 cost recovery method (depreciation) or the income forecast method. According to the revenue rulings, the proper method of cost recovery under section 167, for writings, is the income forecast method. Thus, the depreciation method is the same whether the prepublication expenditures are capitalized under section 280 or other Code sections. On its face, the applicability of section 280 to authors is not at all clear, and the courts have not yet ruled on the issue. An aggressive tax planner should consider this in deciding whether and how to capitalize prepublication expenditures.

Congress, in the Tax Reform Act of 1976, significantly tightened the tax laws affecting authors. The Economic Tax Recovery Act of 1981 and the recent 1982 Tax Act did not loosen any of the provisions specifically affecting authors, so Congress is apparently satisfied for the moment with the tax treatment authors are receiving. Perhaps the courts will rule in the near future as to the applicability of section 2119 and 280 to authors. However, what is really needed is specific legislation indicating whether authors should capitalize their expenses and, if so, what methods of cost recovery they should use to recover them.

126. Rev. Rul. 68-194, *supra* note 33. I.R.C. § 183.